

**Modification Report**  
**Amendments to Operating Margins Pre-emption Rights at LNG sites**  
**Modification Reference Number 0558**  
Version 1.0

This Modification Report is made pursuant to Rule 8.9 of the Modification Rules and follows the format required under Rule 8.9.3.

**1. The Modification Proposal**

The proposed changes are designed to avoid any impact to Transco's Safety Case by maintaining Transco's unlimited "pre-emption" rights. The changes would achieve this by allowing Transco to secure rights to capacity which holds another Users' gas by a form of tender, which would thereby indicate the value of any such pre-emption which Transco decide to exercise.

They are also designed to admit the prospect of varying OM requirements in future years while other Users may have multi-year LNG capacity bookings.

The Proposal would make three changes:-

- i. Initially Transco would have "free" pre-emption rights in respect of LNG capacity up to a quantity at any site which is the greater of:
  - a) the amount of OM gas held in that store at 1 March; and
  - b) the capacity at that site available to all Users for the ensuing Storage Year less the total quantity of gas held in store in firm bookings at 1 March by LNG Users other than by Transco for OM purposes.

This allows the OM Manager free access to all empty or unbooked capacity (case (b) above). Also, in any case where the capacity available to Users is reduced (as with Grain this year) case (a) ensures that the quantity available to the OM manager is never less than his inventory at that storage facility.

- ii. If Transco determine that the above is insufficient for the following Storage Year's OM needs, then Transco would be given scope to "buy" extra pre-emption rights. To this end, Transco would be entitled to publish a tender to buy gas-in-store bundled with capacity rights for the remainder of the current Storage Year. By publishing such a tender Transco would have pre-emption rights to the capacity as defined in (i) and also to the additional capacity holding gas-in-store acquired in the tender process. This places no limit on the extent to which Transco may choose to increase their OM booking for the following Storage Year. The gas acquired would become OM gas in store at the date of acquisition and would reduce the procurement requirements for the ensuing year. This process would mean that a "market price" is determined for the capacity and gas which has to be released to enable the OM booking to be increased. Users should have not less than 7 working days to formulate responses to the tender.
- iii The Code rules need to accommodate the possibility that Transco want additional capacity for OM purposes and publish a tender as above but Users holding such capacity decline to offer sufficient capacity in the tender. In this case, maintaining the integrity of Transco's Safety Case requires that Transco

should have the right to such additional pre-emption as is needed after the tender, irrespective of the impact on other Users and on any ongoing contracts Users may have with Transco LNG.

Thus where Transco seek additional space for OM use, they would in due course need to procure extra gas for this space. Where (but only where) there would be a conflict with other Users' holdings of gas in store, the proposed process advances the gas procurement to precede any release of LNG capacity to other Users, with the aim that by the time of that release of capacity sufficient capacity would normally remain available to accommodate the total amount of gas.

The above changes would require that any long-term contracts between Transco LNG and their Users admit that capacity may have to be capable of being "clawed back" if the capacity left available after Transco's OM requirements are secured is insufficient for Transco LNG to honour all ongoing contracts. This has to be borne in mind in structuring future relationships between Transco LNG and their customers but is not a Network Code issue. Also, it is an issue to be addressed whether or not this Modification is implemented.

## 2. Transco's Opinion

Transco does not support implementation of this Modification Proposal for the following reasons:

- The Network Code Operating Margins rules primarily concern the procurement, use and if necessary, the disposal of Operating Margins Gas. Procurement of storage capacity is governed by Transco's GT Licence, and incentive arrangements are in place. Transco does not believe that a Network Code Modification Proposal is the appropriate means of introducing further incentives which would affect Transco's exposure under its existing Licence conditions.
- Whilst the Proposer emphasises the fact that a holder of storage capacity might become a "distressed seller" in respect of gas-in-storage, there is no reason to believe that requiring Transco to purchase storage capacity prior to the Storage Year would address this perceived short-fall in sales. Transco's purchase of storage capacity in such circumstances would be unlikely to accurately compensate the User but would either under or over compensate. Transco is therefore surprised that the proposed compensation mechanism does not directly address the price differences when these could be determined by reference to WACOG or SAP data.
- OM storage capacity requirements reflect the underlying scenarios which have been discussed with Users. As demand tends to increase each year and Transco's pipe-line system is extended to reflect this, it is inevitable that even the same scenarios would lead to calculation of different OM requirements. Transco also contends that it is appropriate to review the underlying scenarios from time to time as its understanding of the risk elements within its security of supply strategy are refined. Implementation of this Modification Proposal would essentially incentivise Transco to not pursue development of its security strategy to meet changing patterns of supply and demand.

Transco is unaware of any impact implementation of this Modification Proposal would have on the interactions between the gas and electricity regimes and notes that no respondents commented on this issue.

**3. Extent to which the proposed modification would better facilitate the relevant objectives**

The Proposer does not specifically refer to the relationship between implementation of this Modification Proposal and the facilitation of the relevant objectives. In referring to the risk of Users becoming "distressed sellers", it is assumed that the case for implementation is based upon the objective of securing effective competition between relevant Shippers. Transco, however, believes that such risks should be viewed in the context of maintenance of supply security and that there are more appropriate methods of ensuring that sellers of gas-in-storage achieve a fair price.

Transco does not believe that implementation would be consistent with Transco's efficient discharge of its obligations under its Licence, particularly the security of supply obligations that are met by Transco's procurement of OM capacity and gas.

**4. The implications for Transco of implementing the Modification Proposal , including**

**a) implications for the operation of the System:**

Transco is unaware of any implications that implementation would have on the operation of the System.

**b) development and capital cost and operating cost implications:**

Implementation of this Modification Proposal would be expected to have operating cost implications as Transco reviews its System Reserve requirements each year.

**c) extent to which it is appropriate for Transco to recover the costs, and proposal for the most appropriate way for Transco to recover the costs:**

As implementation of this Modification Proposal would change the cost assumptions on which Transco's System Reserve Incentive Target is based, it may be appropriate for Transco's GT Licence to be modified in order to amend this target.

**d) analysis of the consequences (if any) this proposal would have on price regulation:**

Transco is unaware of any implications that implementation would have on price regulation.

**5. The consequence of implementing the Modification Proposal on the level of contractual risk to Transco under the Network Code as modified by the Modification Proposal**

As implementation would open the possibility of Transco trading-in additional storage capacity its level of contractual risk would be expected to increase.

**6. The development implications and other implications for computer systems of Transco and related computer systems of Users**

Transco would need to develop its computer systems to manage an additional trading process but these systems implications would not be expected to be major.

**7. The implications of implementing the Modification Proposal for Users**

Implication of this Modification Proposal would allow Users to sell to Transco storage capacity and gas-in-storage at facilities prior to the Storage Year in the event that Transco increases its Operating Margins bookings.

**8. The implications of implementing the Modification Proposal for Terminal Operators, Consumers, Connected System Operators, Suppliers, producers and, any Non-Network Code Party**

The Storage Operator would be expected to slightly increase its volume of capacity and gas-in-storage trades.

**9. Consequences on the legislative and regulatory obligations and contractual relationships of Transco and each User and Non-Network Code Party of implementing the Modification Proposal**

There would be a minor extension to the contractual relationships between Transco and Users due to the additional tenders required to give effect to implementation of this Modification Proposal.

**10. Analysis of any advantages or disadvantages of implementation of the Modification Proposal**

**Advantages:**

- implementation would potentially yield additional income for Users of Storage Capacity, if Transco issued tenders for purchase of additional storage capacity and gas-in-storage, in order to meet an increased Operating Margins requirement.

**Disadvantages:**

- implementation would increase Transco's cost exposure in its role of managing System Reserve; and
- the additional income for a User would not necessarily compensate for that User's exposure as a distressed seller of storage capacity.

## 11. Summary of the Representations (to the extent that the import of those representations are not reflected elsewhere in the Modification Report)

Four representations were received to the Proposal:

<b>Respondent</b>	<b>Response</b>
British Gas Trading (BGT)	For
Powergen (PG)	For
Scottish Power (SP)	Against
Health & Safety Executive (HSE)	Comments

The following aspects of the Proposal were raised in the representations:

### **Impact on Safety and Security**

HSE noted that "LNG facilities play a key strategic role in the safety case in minimising the risk of a supply emergency through the processes of Operating Margins and Transmission Support". It commented that it was "unable to properly assess the implication of the Proposal ....." and "... would not allow a modification which lead to a diminution in safety standards. One of the key criteria we would look at in making a judgement in this case would be whether Transco would lose control over access to LNG stocks." In its final paragraph, HSE made a general point: "In respect of incentives, we would be concerned with any which undermines Transco's ability to meet its security of supply obligations."

BGT drew attention to the Safety Case issue in its statement that "for Safety Case reasons it is necessary to address the case where Transco chooses to increase its LNG booking at a particular site to the extent that triggers the tender but LNG users choose not to offer sufficient capacity in the tender: in this case the Proposal gives Transco further pre-emption rights - the aim is that the knowledge of this fall-back mechanism should ensure that Users do in fact offer enough capacity at prices they think reasonable, for Transco to take the cheapest."

PG expressed the view that implementation of this Modification Proposal, "will not impact the safe operation of the system because Transco will be able to continue obtaining a certain level of "free" pre-emption rights."

SP commented that "Transco should have an economic efficiency obligation in the procurement of these services subject to safety case requirements."

### **Transco's View**

Transco believes that if this Modification Proposal were implemented, the OM Manager, given unlimited funds, would be able to secure sufficient LNG storage capacity in order to meet locational OM requirements. However, Transco is concerned that in the event that a small number of Users held storage capacity at a particular facility, the OM Manager may have to pay very high prices for the storage capacity and gas-in-store that it would need to secure its pre-emption rights. Transco also has reservations with reliance upon the proposer's "fall-back mechanism". This provides only for insufficient capacity being offered by LNG Users in the tender - not offers made at an uneconomic price. Transco does not believe that introducing the potential for uneconomic purchase of OM storage

capacity is consistent with its GT Licence obligation of efficient and economic operation of its pipe-line system.

### **Users Exposure to Unavoidable Risks**

In summarising the Proposal, BGT commented that it was "designed to ensure that LNG Users can achieve a market value if they collectively ever have to relinquish LNG capacity holding gas to enable Transco to secure sufficient capacity for their OM estimates". In its comments on the present regime, it identified that the "current arrangements by which Transco has to book capacity for OM purposes cause LNG users to become exposed to certain risks." In response to Transco's comment in the Draft Modification Report on more appropriate methods of ensuring that sellers of gas-in-storage achieve a fair price for that gas, it commented that it was "unclear what alternative compensation mechanism Transco is proposing – we are unaware that Transco have advanced an alternative during Network Code meetings discussing this subject."

PG stated that implementation of this Modification Proposal would reduce "user's exposure to unavoidable risks whenever Transco change their OM requirements at an LNG site". It further stated that "Transco should not be able to obtain their OM requirements to the detriment of storage users."

SP expressed the view that "implementation of this Proposal would provide "further structure to a process of securing a service which may be more economically and efficiently sourced elsewhere." SP concluded that "Transco should contract directly with the required parties for provision of their services with their requirements as elements within the contractual arrangements."

### **Transco's View**

Transco reiterates its view that implementation of this Modification Proposal would not be expected to achieve a market value for gas-in-storage as it does not directly address determining the price of such gas. Whilst Transco did not propose any alternative compensation methods during Network Code meetings, where this Modification Proposal was discussed, it did suggest that development of this Proposal should continue in order to seek to establish a method of allocating a fair price for transferring gas-in-storage, without involving capacity issues. The Workstream, however, was of the view that such discussions should take place within the context of development of Contestable System Reserve Services and concluded that the Proposal was sufficiently developed to proceed to consultation.

### **Interaction with Transco Incentives**

BGT did not "regard the proposal as creating any "further incentive", rather it seeks to create a more equitable balance between financial exposures – at present Transco can optimise their costs at (from time to time) their customers' expense". BGT concluded that it did not regard "removing this inequity as creating an "incentive" in any but an obtruse sense."

SP stated that "existing incentives are in place along with obligations relating to Transco's GT licence."

### **Transco's View**

Transco pointed out in the Draft Modification Report that the rules governing procurement, use and disposal, of Operating Margins Gas are governed by Transco's GT Licence, for which incentive arrangements are in place. Transco does not believe that a Network Code Modification Proposal is the appropriate means of introducing further incentives which would affect Transco's exposure under its existing Licence conditions.

### **Locational OM Considerations**

In order to demonstrate the year-on-year changes in OM requirements, BGT highlighted bookings at Avonmouth LNG facility in 2000, 2001 and 2002. It believed that it was "unfair that Transco should be able to minimise their costs associated with non-location-specific OM storage capacity with no concern as to the impact on other capacity users." It further maintained that "The Modification Proposal would not in any way stop Transco redistributing OM bookings where these are necessary, but a substantial amount of the OM LNG requirements are not location-specific." BGT concluded its summary of past practice expressing its belief that "the past changes in the distribution of OM requirements have been considerably influenced by the cost consequences for Transco", and that prior implementation of this Modification Proposal "would only have affected the distribution of non-location specific OM capacity."

### **Transco's View**

Transco is happy to clarify that the instances referred to arose due to changes in locational requirements. As recognised by BGT, the costs of OM capacity procurement have led to Transco procuring this capacity at storage facilities other than LNG and this procurement did not take advantage of any pre-emption rights. Transco would only expect to increase its bookings at an LNG facility if there were an increase in the relevant locational requirement or if the present cost differences changed considerably.

### **Alternative Procurement Strategies**

SP expressed a view that implementation of this Modification Proposal "would provide further structure to a process of procuring a service which may be more economically and efficiently sourced elsewhere". It also expressed a preference for Transco contracting "directly with the required parties for provision of their services with their requirements as elements within the contractual arrangements".

### **Transco's Response**

With the exception of booking non-locational OM capacity on a non-premptive basis at storage facilities, other than LNG facilities, Transco does not, at present, have the ability to procure OM capacity elsewhere. It does, however, understand the views expressed and is proposing to launch parallel running of demand-side contestable services for the Storage Year 2003/4 as a potential prelude to the adoption of a fully contestable regime. Transco believes that discussion on pre-emption rights could be an integral part of the consultation that would take place in order to implement the full regime.

**12. The extent to which the implementation is required to enable Transco to facilitate compliance with safety or other legislation**

Implementation is not required to facilitate compliance with safety or other legislation.

**13. The extent to which the implementation is required having regard to any proposed change in the methodology established under Standard Condition 4(5) or the statement furnished by Transco under Standard Condition 4(1) of the Licence**

Transco is unaware of any such requirement.

**14. Programme of works required as a consequence of implementing the Modification Proposal**

A programme of works for the minor system changes would be required if this Modification Proposal were implemented but these have not been identified at this stage.

**15. Proposed implementation timetable (including timetable for any necessary information systems changes)**

As Transco does not support implementation, no implementation timetable is suggested.

**16. Recommendation concerning the implementation of the Modification Proposal**

Transco does not recommend implementation of this Modification Proposal.

**17. Restrictive Trade Practices Act**

If implemented this proposal will constitute an amendment to the Network Code. Accordingly the proposal is subject to the Suspense Clause set out in the attached Annex.

**18. Transco's Proposal**

This Modification Report contains Transco's proposal not to modify the Network Code and Transco now seeks agreement from the Gas & Electricity Markets Authority in accordance with this report.



## **19. Text**

Signed for and on behalf of Transco.

Signature:

**Tim Davis**  
**Head of Regulation NT&T**

Date: